MINUTES
of the
FIRST MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

June 16, 2015
Room 322, State Capitol
Santa Fe, New Mexico

The first meeting of the Investments and Pensions Oversight Committee for the 2015 interim was called to order by Senator George K. Munoz, chair, on Tuesday, June 16, 2015, at 9:15 a.m. in Room 322 of the State Capitol in Santa Fe.

Present
Sen. George K. Munoz, Chair
Rep. Monica Youngblood, Vice Chair
Sen. Jacob R. Candelaria
Rep. Miguel P. Garcia
Sen. Bill B. O'Neill
Rep. Jane E. Powdrell-Culbert
Rep. William "Bill" R. Rehm
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. Sue Wilson Beffort
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Steven P. Neville
Sen. William P. Soules

Advisory Members
Sen. Ted Barela
Rep. Roberto "Bobby" J. Gonzales
Sen. John C. Ryan
Rep. Tomás E. Salazar
Rep. James E. Smith
Rep. Sheryl Williams Stapleton

Sen. Carlos R. Cisneros
Sen. Stuart Ingle
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Sen. William H. Payne
Sen. Michael S. Sanchez

Staff
Lisa Sullivan, Staff Attorney, Legislative Council Service (LCS)
Ric Gaudet, LCS
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS

Guests
The guest list is in the meeting file.

Handouts
Handouts and other written testimony are in the meeting file.

Tuesday, June 16

Public Employees Retirement Association (PERA): Overview of Governmental Accounting Standards Board (GASB) Statements 67 and 68

Natalie Cordova, chief financial officer, PERA, and Jeff Bridgens, Moss Adams, LLP, provided the committee with an overview of the manner in which the PERA is implementing GASB Statements 67 and 68. Ms. Cordova explained that the GASB is the independent organization that establishes standards of accounting and financial reporting for state and local governments and is recognized by governments as their official source of generally accepted accounting principles. She commented that while standards established by the GASB do not have the force of law, compliance with the standards is critical to auditors who render opinions based upon the conformity of financial statements with generally accepted accounting principles. Ms. Cordova mentioned that failure to comply with the GASB's standards could result in modified audit opinions and affect bond ratings of government entities.

Ms. Cordova stated that changes issued by the GASB under its Statements 67 and 68 are intended to provide for improved consistency and transparency in employer reporting. Through those statements, the GASB requires governments to report their net pension liabilities on the face of their financial statements. She also stated that the inclusion of net pension liabilities is intended to permit users of financial statements to better assess the long-term benefit obligations and the long-term financial health of the government entity. In addition, Ms. Cordova stated that the disclosure is meant to provide information on whether the government entity is meeting its pension obligations.

Ms. Cordova described the differences between GASB Statements 67 and 68. She stated that GASB Statement 67 applies to entities that administer pension benefits, such as the PERA and the Educational Retirement Board (ERB). She explained that the PERA administers a cost-sharing multiple employer defined benefit plan, which covers state employees from each branch of government and local government employees. Ms. Cordova stated that GASB Statement 68 applies to government entities that provide pension benefits to their employees. Those government entities might include counties, municipalities, housing authorities and water and sanitation districts.

Ms. Cordova discussed some of the characteristics of pension plans, indicating that pension plans are considered as part of an employee's total compensation and that an employer incurs a pension obligation as a result of an employment exchange. She said that a principle underlying recent changes effected by the GASB is that the costs attributable to pension benefits should be recognized in the period the services are provided. Ms. Cordova noted that while the pension plan is primarily responsible for paying pension benefits to the extent sufficient assets are available, the employer is responsible for paying benefits not covered by the assets of the pension plan.

As a result of the changes effected by the GASB, net pension liabilities are now to be reported on employer balance sheets. Ms. Cordova explained that the net pension liability is effectively the total pension liability, less a pension plan's fiduciary net position, or market value of assets. To calculate the total pension liability, the total future pensions of current and former employees are calculated based on the terms of the pension plan and certain actuary assumptions, such as projected salaries and the periods during which the employees are expected to work and collect retirement benefits. The present values of the projected benefits are determined and then attributed to past and future earning periods. Ultimately, a pension plan's fiduciary net position is subtracted from the total pension liability to determine the net pension liability.

Ms. Cordova discussed the difference between the net pension liability of $3.3 billion reported by the PERA and its unfunded actuarial accrued liability (UAAL) of $4.3 billion as of June 30, 2014. She stated that the market value of assets or the fiduciary net position is greater than the value of assets used in the June 30, 2014 actuarial valuations. She also explained that the calculation of the fair market value of assets is often more volatile relative to the actuarial value of assets used to calculate the UAAL because of a four-year smoothing feature characteristic of the UAAL. She stated that the net pension liabilities of the PERA divisions and funds are less than their UAALs in the 2014 actuarial valuation, with the exception of the Magistrate Retirement Fund. That fund is the only fund projected to become insolvent using the GASB Statement 67 projection method. Thus, a lower blended discount rate will be applied, resulting in an increase to the net pension liability attributable to the Magistrate Retirement Fund under the new GASB standards.

Ms. Cordova explained that the PERA is responsible for implementing GASB Statement 67 and including the required information in the PERA's financial report for fiscal year 2014. She added that the PERA is also assisting various employers in the collection of data necessary for their implementation of GASB Statement 68. For fiscal year 2015, Ms. Cordova stated that the PERA is paying for the calculation of employer allocations and related audits for each entity participating in the PERA pension plan. She also described the process by which pension contribution data will be incorporated into a schedule of employer allocations. A schedule of employer allocations would include, for each employer, its share of net pension liability, deferred inflows and outflows, pension expense and a rate-sensitivity disclosure.

Ms. Cordova presented a report showing the components of the separate net pension liabilities of the PERA's members, according to the fund. The reported net pension liabilities included: $3.3 billion for the PERA; $41 million for the Judicial Retirement Fund; and $21 million for the Magistrate Retirement Fund. A negative pension liability of $21 million was reported for the Volunteer Firefighters Retirement Fund.

Mr. Bridgens discussed the significance of discount rate assumptions upon the PERA's net pension liability calculations. He said that the discount rate used to calculate net pension liabilities was 7.75 percent, but that net pension liability calculations are sensitive to changes in the discount rate. He presented a table that showed the changes in net pension liabilities relative to one percent changes in discount rates. For instance, the PERA's calculated net pension liability is $3.3 billion if a discount rate of 7.75 percent is used. However, if the discount rate is reduced by one percent to 6.75 percent, the net pension liability is increased to $5.5 billion. On the other hand, if the discount rate is raised to 8.75 percent, the net pension liability is reduced to $1.6 billion. Mr. Bridgens explained that GASB Statement 67 requires a note disclosure of the effect of such discount rate changes.

Mr. Bridgens additionally discussed the impact of GASB Statement 67 on the manner in which raw data inputs are collected and used in the calculation of liability projections. He explained that demographic data, such as pension member birth dates, gender, wage information and other data, are increasingly being audited because these data are critical in making total pension liability and UAAL calculations. Mr. Bridgens said that the PERA's external and internal auditors annually perform test work on such data.

Questions and comments from committee members followed. A committee member asked whether the standards established by the GASB were used by states with defined benefit plans and states with defined contribution plans. Mr. Bridgens explained that GASB Statement 67 applies to both defined contribution plans and defined benefit plans. In addition, a committee member asked if GASB standard compliance is required by New Mexico law. Susan Pittard, general counsel, PERA, referenced some requirements, such as the state audit rule, which have been modified to address changes made by the GASB.

A committee member asked about any actions that might be taken with respect to the projected insolvency of the Magistrate Retirement Fund. Ms. Cordova explained that a blended discount rate of about 5.96 percent will be applied to reflect the contributions to the fund and benefits to be paid. Wayne Propst, director, PERA, added that legislation passed in 2014 would assist with returning the Magistrate Retirement Fund to solvency. He noted that the effects of legislation upon that fund's solvency would be realized later than the effects of 2013 legislation aimed at assisting with the solvency of other retirement funds.

A committee member additionally inquired about the internal and external audits conducted with respect to demographic data used for net pension liability calculations. Mr. Bridgens noted that audits are often coordinated to avoid a duplication of effort with respect to the review of demographic information. Another question arose with respect to whether administrators of pension funds in other states are increasingly focusing on audits of demographic data. Mr. Bridgens indicated that other states are doing so.

A committee member inquired about the extent to which the PERA is meeting its annual funding requirements. Mr. Propst stated that the PERA is meeting its statutorily required contributions, and he explained that its existing UAAL is attributable to a market downturn during the recession, when the PERA funds lost half of their value. Mr. Propst added that legislation on pension reform from 2013 would assist the PERA in eventually paying off its UAAL in the long term. A committee member asked when the PERA estimates that the UAAL would be eliminated. Mr. Propst responded that, with an assumed discount rate of 7.75 percent, it would take 20 years for the PERA to reach a level at which it is 100 percent funded.

Committee members and Ms. Cordova discussed how net pension liabilities for state-administered funds might be reflected in the comprehensive annual financial report. A committee member asked about the effect that UAALs might have on the bond ratings of government entities. Mr. Propst stated while there has not necessarily been a correlation with the reporting requirements stemming from GASB Statements 67 and 68, there is a chance that pension reform legislation in 2013 could be considered favorably by bond rating agencies.

A committee member asked which investment agencies are affected by GASB Statement 67. Mr. Propst explained that it applies to the PERA and the ERB. He added that the GASB recently issued statements that will affect the Retiree Health Care Authority and will change how it reports its funding status.

A committee member asked about a settlement reached between the PERA and Wells Fargo stemming from a lawsuit for breach of contract and breach of fiduciary duty filed by the PERA in 2010 against Wachovia Bank. Wells Fargo subsequently acquired Wachovia Bank. Mr. Propst stated that the parties reached a settlement resulting in a recovery of $50 million for the PERA. Ms. Pittard stated that the settlement amounts are currently in transition. A committee member asked whether the PERA would incur attorney fees. Ms. Pittard indicated that attorney fees would be paid to outside counsel.

A committee member suggested that the committee consider review of the balances in the Legislative Retirement Fund and asked the PERA staff about the status of the fund. Mr. Propst stated that the fund currently holds a balance of $7.5 million, and its funded ratio is 129.3 percent. He stated that it is anticipated that the fund balance will continue to grow as it continues to receive member contributions and statutory distributions.

State Investment Council (SIC): Overview of Current Investment Theories and Trends and Investment Details for 2008-2014

Vince Smith, deputy state investment officer, SIC, provided an overview of a number of economic factors affecting the SIC's investments of public funds. In particular, he noted that inflation is expected to stay within the average range, between two and five percent, within the next seven to 10 years. Gross domestic product growth is expected to range between 3.5 and six percent, but a rate of about five percent is generally characteristic of overall corporate strength. He noted that during the last 10 years, the growth rate for global stocks was at about six percent, but that rate is expected to approximate 6.5 percent within the next seven to 10 years. He also noted that the growth rate for stocks and bonds, within a basic "60 to 40" allocation model, is expected to approximate 5.5 percent.

Overall, Mr. Smith noted that the SIC is anticipating lower-than-average investment returns for the next seven to 10 years. He explained that expected rate of return is composed of a risk-free rate of return and a risk premium. The risk-free rate has dropped to two percent from five percent, thus reducing the expected rate of return for all asset classes. Mr. Smith presented the committee with a chart showing the historical risk-free rates and risk premia from 1998 through 2014. He stated that for the SIC to achieve its long-term target return of 7.5 percent over the next seven to 10 years, a risk premium of 5.25 percent would need to be achieved and would present challenges. He pointed out that while public funds earned a median of almost 8.75 percent annually over the last 20 years, market conditions have changed. He pointed out that the Shiller price-to-earnings ratio, a measure of stock market valuation, has risen from about 10 in 1985 to about 27 in 2015. He also pointed out that bond yields have decreased from 10 percent in 1985 to four percent in 2015.

Mr. Smith described the SIC's strategy in light of the current market and economy. He stated that the SIC's strategy will focus on reducing a dependence on equity risk premiums; incorporating more real return assets; increasing income-producing assets relative to capital gain assets; increasing international exposure; and reducing publicly traded assets, while increasing private assets.

Mr. Smith explained how the SIC diversifies investments to serve the needs of each fund and client. He clarified that the staff members of the SIC do not act as investment advisors. He presented a chart showing the current percentages invested by the SIC in different types of assets. While 23 percent of the SIC's investments constitute fixed-income investments, another 27 percent is invested in private market investments and 50 percent is invested in public equity.

Mr. Smith talked about the SIC's investment in publicly traded investments, including stocks and bonds. He said that those investments are externally managed and internally monitored. He added that the SIC increased its allocation toward passive investments in 2014. Management fees are paid quarterly, but the SIC does not pay performance incentive fees. Instead, manager payments are based on the size of the funds managed. He noted that a management fee maximum of 25 basis points has been eliminated in an effort to recruit high-quality managers. Mr. Smith also stated that the SIC has structured its portfolio of active managers to provide protection during down-cycle markets. The SIC has reduced reliance on equity markets and has shifted toward income-producing assets.

Next, Mr. Smith provided an overview of the management of the SIC's private equity investments outside of New Mexico. There are 110 private equity funds invested by 78 managers. He indicated that the investment managers for those private equity funds receive a portion of profits as part of their fee structures. The SIC's target asset allocation for private equity fund investments constitutes 12 percent of its portfolio. In addition, there are 19 private equity funds invested in New Mexico companies by 13 managers. Those funds are invested in passive investments, primarily focused on venture capital and technology transfer. The SIC's target asset allocation for those investments is five percent of the market value of the Severance Tax Permanent Fund, but an asset allocation of up to nine percent is permitted by statute.

Mr. Smith indicated that the SIC has shifted its real estate investments to real estate funds in primary markets. He stated that the SIC is working toward achieving an investment allocation target for this category of 10 percent within the next couple of years. Mr. Smith additionally discussed other strategies used by the SIC, including those using absolute return techniques and those that focus on credit and structured debt.

Mr. Smith and Steven K. Moise, state investment officer, SIC, indicated that the SIC's primary investment consultant is RVK, which provides the SIC with monthly and quarterly investment reporting; manager research and performance monitoring; and portfolio construction and strategic planning. They also provided a list of investment consultants used for specific investment strategies. They indicated that those investment consultants provide quarterly performance reporting to the SIC, in addition to manager recommendations and ongoing fund monitoring.

Mr. Moise and Mr. Smith presented a detailed report showing balances and returns of the Land Grant Permanent Fund and Severance Tax Permanent Fund since 1989. While the SIC has established an investment return target of 7.5 percent, Mr. Moise and Mr. Smith indicated that the SIC will assess later this year whether that target is still appropriate.

Mr. Smith presented a table, produced by the Legislative Finance Committee, showing the performance rankings with respect to the funds invested by the SIC, the PERA and the ERB. Brent Shipp, chief financial officer, SIC, presented statements of net position and the contributions and distributions relative to the funds invested by the SIC since fiscal year 2008. The SIC staff also presented an analysis of investment management and other fees paid by the SIC since fiscal year 2008. In addition, the staff presented a comparison of fees relative to the ERB and the PERA.

Mr. Smith stated that investments by the SIC are managed entirely by external managers and that the SIC does not pay broker fees. With respect to placement agents, Mr. Smith said the SIC has never paid placement fees. The SIC's lawsuits against placement agents and funds has resulted in recoveries of about $32 million. Mr. Smith also provided a brief description of the transparency and disclosure policy enacted by the SIC in 2010, which requires disclosure of campaign contributions by investment funds and the ban of placement agents by investment officers.

Mr. Moise stated that the SIC will study and approve an investment plan for the next year, and he noted that the SIC manages about $20.8 billion in public funds. Distributions to the Land Grant Permanent Fund and Severance Tax Permanent Fund for fiscal year 2016 are expected to reach $849.3 million. He reiterated that the staff and members of the SIC are fiduciaries of those funds. Harold Lavender, member, SIC, spoke briefly about the SIC's development of investments.

Comments and questions by the committee members followed. A committee member asked how payments of private equity investment managers compare to payments of investors of publicly traded investments. Mr. Moise stated that for publicly traded investments, investment management fees are proportional to the size of the assets invested. For private equity investors, the management fees increase as profits rise.

Committee members discussed whether additional investments could be made to promote New Mexico business growth. Mr. Moise indicated that the SIC requested Sun Mountain Capital, its New Mexico private equity consultant, to conduct a pacing study focused upon how much money the SIC could prudently invest in New Mexico businesses. The study resulted in a target allocation for New Mexico private equity investments of five percent. In response to a question as to whether that percentage might change, Mr. Moise indicated that the SIC has tasked Sun Mountain Capital with a study of what could be done to improve investment in New Mexico businesses. Committee members also discussed the effects of efforts within recent years to diversify Land Grant Permanent Fund investments and to increase inflows to the Severance Tax Permanent Fund.

A committee member asked why the SIC's expenditures for contractual services have increased over the past few years. Mr. Shipp indicated that the SIC's assets are growing, accounting for the increase in fees. He noted that fees had increased from 19 basis points in fiscal year 2008 to 26 basis points in fiscal year 2014.

2015 Interim Work Plan and Meeting Schedule

Ms. Sullivan presented the committee's proposed work plan and meeting schedule for the 2015 interim. Ms. Sullivan noted a change to the proposed work plan, which would require reports on the effect of GASB Statements 67 and 68 on government entities. The committee adopted the revised, proposed work plan, with other additions, including items to permit the committee to study the Legislative Retirement Fund and the investment of the Severance Tax Permanent Fund in private equity funds or New Mexico businesses.

Adjournment

There being no further business before the committee, the committee adjourned at 12:30 p.m.